

**Initial Statement of Reasons for
Proposed Amendments to California Code of Regulations,
Title 18, Section 1705, *Relief From Liability***

**SPECIFIC PURPOSE, PROBLEM INTENDED TO BE ADDRESSED, NECESSITY, AND
ANTICIPATED BENEFIT**

Current Law

Revenue and Taxation Code (RTC) section 6005 defines the term “person” for purposes of the Sales and Use Tax Law (Rev. & Tax. Code, § 6001 et seq.). It currently provides that the term includes “any individual, firm, partnership, joint venture, limited liability company, association, social club, fraternal organization, corporation, estate, trust, business trust, receiver, assignee for the benefit of creditors, trustee, trustee in bankruptcy, syndicate, the United States, this state, any county, city and county, municipality, district, or other political subdivision of the state, or any other group or combination acting as a unit.”

Currently, under RTC section 6596, subdivision (a), if the State Board of Equalization (Board) finds that a person’s failure to make a timely return or payment is due to the person’s reasonable reliance on written advice from the Board, the person may be relieved of sales and use taxes and any penalties or interest added thereto (hereafter referred to as RTC section 6596 relief). Currently, under RTC section 6596, subdivision (b), a person’s failure to make a timely return or payment is due to reasonable reliance on written advice from the Board only if the Board finds that:

- The person submitted a written request to the Board for advice about whether a particular activity or transaction is subject to sales and use tax and fully described the specific facts and circumstances of the activity or transaction in the request;
- The Board responded to the written request for advice in writing and stated whether or not the described activity or transaction is subject to tax, or stated the conditions under which the activity or transaction is subject to tax;
- In reasonable reliance on the Board’s written advice, the person did not charge sales tax reimbursement or collect use tax from his or her customers or pay a use tax on the described activity or transaction; and
- The liability for taxes due to the failure to make a timely return or payment applied to a particular activity or transaction which occurred before the Board rescinded or modified the written advice or the Board’s earlier written advice ceased to be valid due to a change in the law.

In addition, under RTC section 6596, subdivision (c), a person requesting RTC section 6596 relief is currently required to file with the Board a copy of the person’s written request to the Board for advice, a copy of the written advice the Board provided in response, the person’s statement under penalty of perjury setting forth the facts on which the person’s request for relief is based, and any other information the Board requires. And, currently, RTC section 6596,

subdivision (d), generally provides that “[o]nly the person making the written request shall be entitled to rely on the [B]oard’s written advice to that person.”

California Code of Regulations, title 18, section (Regulation) 1705, *Relief From Liability*, implements, interprets, and makes specific the provisions of RTC section 6596. As relevant here:

- Regulation 1705, subdivision (b)(1), currently requires that a representative’s written request for advice identify the specific person for whom the advice is requested in order for the identified person to rely on the advice in the Board’s written response to the representative for RTC section 6596 relief;
- Regulation 1705, subdivision (c) currently applies to audits, states that the “[p]resentation of [a] person’s books and records for examination by an auditor shall be deemed to be a written request for the audit report,” and prescribes the circumstances under which an audit report may be relied upon for RTC section 6596 relief; and
- Regulation 1705, subdivision (a), currently provides that “[w]ritten advice from the Board which was received during a prior audit of the person under the conditions set forth in subdivision (c) below, may be relied upon by the person audited or by a legal or statutory successor to that person.”

Also, as relevant here, subdivision (e) was added to Regulation 1705 in 1999 to explain the circumstances under which a trade or industry association may request written advice on behalf of its members so that the members can rely on the written advice for RTC section 6596 relief. The first sentence of Regulation 1705, subdivision (e), which was included in the 1999 amendments, currently provides that “[a] trade or industry association requesting advice on behalf of its member(s) must identify and include the specific member name(s) for whom the advice is requested for relief from liability under this regulation.”

Further, as relevant here, in 2009, the second sentence was added to subdivision (e) of Regulation 1705 to explain the circumstances under which a franchisor may request written advice on behalf of its franchisees so that the franchisees can rely on the written advice for RTC section 6596 relief. The second sentence of Regulation 1705, subdivision (e), currently provides that “[a] franchisor requesting advice on behalf of its franchisee(s) must identify and include the specific franchisee name(s) for whom the advice is requested for relief from liability under this regulation.”

Furthermore, at the same time in 2009, the second paragraph was added to subdivision (e) of Regulation 1705. The second paragraph explains that “[f]or an identified trade or industry member or franchisee to receive relief based on advice provided in the written communication to the trade or industry association or franchisor, the activity or transactions in question must involve the same facts and circumstances as those presented in the written inquiry by the association or franchisor.”

As a result, a person cannot generally obtain RTC section 6596 relief by relying on written advice the Board gave to another person, even if their activities or transactions are similar. However, Regulation 1705 does currently allow a person to obtain RTC section 6596 relief by

relying on written advice the Board gave to the person's representative, trade or industry association, or franchisor under specified circumstances.

Proposed Amendments

Need for Clarification

During its October 23-25, 2012, Board meeting, the Board conducted a hearing regarding a sales and use tax appeal filed by a business entity (hereafter referred to as ABC). During the hearing, ABC indicated that it followed written advice provided during the Board's prior audit of another business entity (hereafter referred to as XYZ). ABC stated that ownership of XYZ was similar to ABC, and that the two companies engaged in the same type of business in the same industry and shared a common accounting department. Also, records indicated that XYZ and ABC were related entities because XYZ owned more than 50 percent of ABC. Therefore, during the hearing, ABC argued that written advice provided to XYZ during its prior audit was indirectly provided to ABC as well, and that ABC should be permitted to rely on the written advice for RTC section 6596 relief. In response to ABC's arguments, the Board referred an issue (or problem within the meaning of Gov. Code, § 11346.2, subdivision (b)(1)) to the Board's Business Tax Committee for further development. The issue was whether RTC section 6596 relief should only be available to the person who actually received the written advice from the Board or that person's legal or statutory successor under certain circumstances, such as those presented in ABC's appeal.

Business Taxes Committee staff subsequently reviewed the facts of ABC's appeal discussed above. First, staff found that when two persons in the same industry are under common ownership and share accounting functions and accounting staff, and the accounting staff presents one of the person's books and records to Board staff during an audit, then it would be reasonable for the accounting staff, under the direction of a common controlling ownership, to rely on the Board's written advice regarding the application of tax to the activities or transactions at issue in the audit report when conducted by the audited person and the related person. Second, staff found that, in this specific factual situation, the presentation of the audited person's books and records should be deemed to be a written request for the audit report by both the audited person and the related person so that RTC section 6596 relief will apply to a liability the audited person or the related person (having the above characteristics) incurs due to either of their reasonable reliance on the written advice Board staff provided in the audit report. Therefore, staff determined that it was necessary to clarify Regulation 1705 accordingly.

However, the facts of ABC's appeal concerned the issue of ABC's reliance on an audit report subject to the provisions of Regulation 1705, subdivision (c), not ABC's reliance on written advice requested under the circumstances described in Regulation 1705, subdivision (b). Also, Business Taxes Committee staff found that if two persons in the same industry are under common ownership and share accounting functions and accounting staff, then Regulation 1705, subdivision (b) already provides a procedure for their joint representatives to request written advice from the Board that identifies both persons by name so that both persons can subsequently rely upon the written advice for RTC section 6596 relief. And, staff found that continuing to require a request for written advice submitted on behalf of two related persons to

comply with the procedures in Regulation 1705, subdivision (b), is consistent with the procedures in Regulation 1705, subdivision (e) requiring a trade or industry association's or franchisor's request for written advice on behalf of its member(s) or franchisee(s) to specifically identify the member(s) or franchisee(s) that may rely on the written advice for RTC section 6596 relief. Therefore, staff did not determine that there was a need to further clarify when related persons may rely on written advice requested from the Board outside of the audit context.

Interested Parties Process

As a result, Business Taxes Committee staff drafted amendments to Regulation 1705, subdivisions (a) and (c). The draft amendments suggested adding language to the end of the first sentence in subdivision (c) to clarify that the presentation of a person's books and records for examination by an auditor shall be deemed to be a written request for the audit report "by the audited person and any person with shared accounting and common ownership with the audited person." The draft amendments suggested adding language to the end of subdivision (c) to clearly prescribe the circumstances under which a person has shared accounting and common ownership with an audited person, and require that all of the circumstances exist at the time that an audit report is provided to the audited person in order for the person with shared accounting and common ownership to rely on the audit report for RTC section 6596 relief. The draft amendments also suggested amending subdivision (a) to clarify that written advice provided under the circumstances described in subdivision (c) may be relied upon by the person audited "or a person with shared accounting and common ownership with the audited person."

Business Taxes Committee staff subsequently provided its draft amendments to Regulation 1705 to the interested parties and conducted an interested parties meeting to discuss the draft amendments in April 2013. During the meeting, a participant questioned the requirement, discussed above, that a person have shared accounting and common ownership with an audited person at the time that an audit report is issued, in order for the person with shared accounting and common ownership to rely on the audited person's audit report for RTC section 6596 relief. The participant expressed concern that the requirement was too narrow and might prevent a person that was not in business when an audit report was issued, but otherwise has shared accounting and common ownership with the audited person, from relying on the audit report for RTC section 6596 relief when it would seem reasonable to rely on the audit report under the circumstances. As a result, staff addressed the concern by revising its draft amendments to Regulation 1705, subdivision (c) so that a person only has to have shared accounting and common ownership with an audited person during the periods that the person is entitled to rely on the audited person's audit report for RTC section 6596 relief.

Business Taxes Committee staff subsequently provided its revised draft amendments to Regulation 1705 to the interested parties and conducted a second interested parties meeting in May 2013. During the meeting, staff received verbal suggestions to add clarifying language and make minor grammatical edits to its revised draft amendments. Therefore, staff made the clarifying and grammatical edits suggested during the meeting, and provided the revised drafts of staff amendments to Regulation 1705 to the interested parties that participated in the May 2013 meeting in case there was a need for further comments.

However, staff did not receive any further comments on its revised drafts of the amendments to Regulation 1705 with the edits suggested at the May 2013 interested parties meeting. Therefore, staff prepared Formal Issue Paper 13-006 and distributed it to the Board Members on August 2, 2013, for consideration at the Board's August 13, 2013, Business Taxes Committee meeting.

August 13, 2013 Business Taxes Committee Meeting

Formal Issue Paper 13-006 recommended that the Board propose to add language to the end of the first sentence in Regulation 1705, subdivision (c), to clarify that the presentation of a person's books and records for examination by an auditor shall be deemed to be a written request for the audit report "by the audited person and any person with shared accounting and common ownership with the audited person." The formal issue paper recommended that the Board propose to add the following language to the end of Regulation 1705, subdivision (c), to clearly prescribe the circumstances under which a person has shared accounting and common ownership with an audited person and require that a person have shared accounting and common ownership with an audited person during the periods that the person is entitled to rely on the audited person's audit report for RTC section 6596 relief:

For the purposes of this section a person is considered to have shared accounting and common ownership if the person:

- (1) Is engaged in the same line of business as the audited person,
- (2) Has common verifiable controlling ownership of 50% or greater ownership or a common majority shareholder with the audited person, and
- (3) Shares centralized accounting functions with the audited person. The audited person routinely follows the same business practices that are followed by each entity involved. Evidence that may indicate sharing of centralized accounting functions includes, but is not limited to, the following:
 - (A) Quantifiable control of the accounting practices of each business by the common ownership or management that dictates office policies for accounting and tax return preparation.
 - (B) Shared accounting staff or an outside firm who maintain books and records and prepares sales and use tax returns.
 - (C) Shared accounting policies and procedures.

These requirements must be established as existing during the periods for which relief is sought. A subsequent written notification stating that the advice was not valid at the time it was issued or was subsequently rendered invalid to any party with shared accounting and common ownership, including the audited party, serves as notification to all parties with shared accounting and common

ownership, including the audited party, that the prior written advice may not be relied upon as of the notification date.

The formal issue paper also recommended that the Board amend Regulation 1705, subdivision (a), to clarify that written advice provided under the circumstances described in subdivision (c) may be relied upon by the person audited “or a person with shared accounting and common ownership with the audited person.”

Mr. Joseph Vinatieri of Bewley, Lassleben & Miller, LLP, appeared at the August 13, 2013, Business Taxes Committee meeting. He expressed his support for the amendments to Regulation 1705 recommended in the formal issue paper, and said the amendments are:

- Fair to taxpayers;
- Narrowly crafted to address the issue presented by the facts of ABC’s appeal; and
- Consistent with the legislative intent underlying the enactment of RTC section 6596.

Therefore, at the conclusion of the Board’s discussion of Formal Issue Paper 13-006 during the August 13, 2013, Business Taxes Committee meeting, the Board Members unanimously voted to propose the amendments to Regulation 1705 recommended in the formal issue paper.¹ The Board determined that the proposed amendments to Regulation 1705 are reasonably necessary for the specific purpose of addressing the issue (or problem) presented by the facts of ABC’s appeal (discussed above).

The Board anticipates that the proposed amendments to Regulation 1705 will promote fairness and benefit taxpayers, Board staff, and the Board by clarifying that RTC section 6596 relief can apply to a person who the Board would reasonably expect to rely on written advice provided by Board staff in a prior audit of another related person because the two persons are:

- In the same industry;
- Under common ownership; and
- Share accounting functions and accounting staff.

The adoption of the proposed amendments to Regulation 1705 is not mandated by federal law or regulations. There is no previously adopted or amended federal regulation that is identical to Regulation 1705.

DOCUMENTS RELIED UPON

The Board relied upon Formal Issue Paper 13-006, the exhibits to the issue paper, and the comments made during the Board’s discussion of the issue paper during its August 13, 2013,

¹ The Board made two minor grammatical changes to the text of the proposed amendments to Regulation 1705, subdivision (c), recommended in Formal Issue Paper 13-006 prior to beginning the rulemaking process. The Board inserted the word “has” between the words “or” and “a” in the proposed amendments adding paragraph (2) to subdivision (c). The Board also added a “s” to the end of the word “maintain” in the proposed amendments adding paragraph (3)(B) to subdivision (c).

Business Taxes Committee meeting in deciding to propose the amendments to Regulation 1705 described above.

ALTERNATIVES CONSIDERED

The Board considered whether to begin the formal rulemaking process to adopt the proposed amendments to Regulation 1705 at this time or, alternatively, whether to take no action at this time. The Board decided to begin the formal rulemaking process to adopt the proposed amendments to Regulation 1705 at this time because the Board determined that the proposed amendments are reasonably necessary for the reasons set forth above.

The Board did not reject any reasonable alternative to the proposed amendments to Regulation 1705 that would lessen any adverse impact the proposed action may have on small business or that would be less burdensome and equally effective in achieving the purposes of the proposed action. No reasonable alternative has been identified and brought to the Board's attention that would lessen any adverse impact the proposed action may have on small business, be more effective in carrying out the purposes for which the action is proposed, would be as effective and less burdensome to affected private persons than the proposed action, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provision of law than the proposed action.

INFORMATION REQUIRED BY GOVERNMENT CODE SECTION 11346.2, SUBDIVISION (b)(6) AND ECONOMIC IMPACT ASSESSMENT REQUIRED BY GOVERNMENT CODE SECTION 11346.3, SUBDIVISION (b)

As previously explained, RTC section 6596, subdivision (c), currently requires a person requesting RTC section 6596 relief to file with the Board a copy of the person's written request to the Board for advice, a copy of the written advice the Board provided in response, the person's statement under penalty of perjury setting forth the facts on which the person's request for relief is based, and any other information the Board requires.

As previously explained, the proposed amendments to Regulation 1705:

- Clarify that the presentation of a person's books and records for examination by an auditor shall be deemed to be a written request for the audit report "by the audited person and any person with shared accounting and common ownership with the audited person";
- Clarify that written advice provided in an audit may be relied upon by the person audited "or a person with shared accounting and common ownership with the audited person";
- Clearly prescribe the circumstances under which a person has shared accounting and common ownership with an audited person; and
- Require that a person have shared accounting and common ownership with an audited person during the periods that the person is entitled to rely on the audited person's audit report for RTC section 6596 relief.

As a result, the proposed amendments will permit some additional persons to qualify for RTC section 6596 relief, and choose to incur any costs associated with requesting relief under RTC

section 6596, subdivision (c). However, the proposed amendments do not require any person to rely on another person's audit report or file a request for relief under RTC section 6596. Therefore, the proposed amendments do not impose any costs on any persons, including businesses.

Furthermore, there is a limited class of persons that will actually have the shared accounting and common ownership with one or more other persons described in the proposed amendments to Regulation 1705. And, each person in the limited class will only be eligible for RTC section 6596 relief due to the person's reliance on another person's audit report during the periods that the person actually has the shared accounting and ownership with the other person and actually relies on the other person's audit report. Therefore, the proposed amendments to Regulation 1705 will provide some relief to some of the persons in the limited class described above. However, the proposed amendments will not benefit every person in the limited class described above, they will not have any impact on persons that are not part of the limited class described above, and the Board does not anticipate receiving a significant number of new requests for RTC section 6596 relief due to the proposed amendments.

Therefore, based on these facts and all of the information in the rulemaking file, the Board has determined that the adoption of the proposed amendments to Regulation 1705 will neither create nor eliminate jobs in the State of California nor result in the elimination of existing businesses nor create or expand business in the State of California.

In addition, Regulation 1705 does not regulate the health and welfare of California residents, worker safety, or the state's environment. Therefore, the Board has also determined that the adoption of the proposed amendments to Regulation 1705 will not affect the benefits of Regulation 1705 to the health and welfare of California residents, worker safety, or the state's environment.

The forgoing information also provides the factual basis for the Board's initial determination that the adoption of the proposed amendments to Regulation 1705 will not have a significant adverse economic impact on business.

The proposed amendments to Regulation 1705 may affect small businesses.